ORIGINAL

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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF PIMA UTILITY COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO: W-02199A-11-0329
IN THE MATTER OF THE APPLICATION OF PIMA UTILITY COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS WASTEWATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO: SW-02199A-11-0330 **NOTICE OF FILING**

Pima Utility Company hereby submits this Notice of Filing in the above-referenced matter. Filed herewith is the summary of Marc Spitzer's pre-filed testimony.

RESPECTFULLY SUBMITTED this 29th day of May, 2012.

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ORIGINAL and thirteen (13) copies of the foregoing were delivered this 29th day of May, 2012, to:

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Pima Utility Company
Docket Nos. W-02199A-11-0329 and SW-02199A-11-0330

Marc L. Spitzer Testimony Summary

Mr. Spitzer is a partner in the Washington, D.C. office of Steptoe & Johnson LLP, where he is a member of the Regulatory & Industry Affairs Department. His current law practice is in the area of Federal and State utilities regulation. Mr. Spitzer has been an attorney and member of the State Bar of Arizona since 1982. His law practice largely involved the representation of taxpayers in proceedings against the Internal Revenue Service. He practiced law continuously from 1982 through 2006, and was certified as a Specialist in tax law by the State Bar of Arizona from 1986 through 2006.

In 1992, he was elected to the Arizona State Senate where he served as chair of the Senate Judiciary and Finance committees, and in 1996-1997 he served as Senate Majority Leader. In 2000, he was elected to the Arizona Corporation Commission ("Commission"), where he served until 2006. President George W. Bush nominated him to the Federal Energy Regulatory Commission ("FERC") in 2006, was confirmed by the United States Senate on July 14, 2006, and served on FERC until December 2011.

Mr. Spitzer is testifying as an expert witness in support of Pima Utility Company's ("Pima") request to recover income taxes as part of its cost of service. A summary of his prefiled testimony follows.

Law and Policy.

Pima is a "pass-through" entity that generates taxable income recognized by its shareholders, who pay tax on that income *pro rata.* The income taxes paid by Pima's shareholders arise directly from Pima's net income from utility operations. Those taxes are part of the cost of service of Pima's utility operations.

There are three arguments raised against Pima's income tax allowance. First, it has been argued, chiefly before FERC, that the use of a tax pass-through entity to conduct business is nefarious and/or illegal. Second, it is argued that pass-through income taxes are "phantom." Third, it is argued the income taxes paid by Pima's shareholders represent "personal" income taxes ineligible for cost of service treatment because the tax payments are submitted with Forms 1040 filed by Pima's shareholders.

Mr. Spitzer's testimony counters each of these arguments. He explains that while he was a FERC Commissioner, that agency carefully considered the issue of tax allowances for pass-through entities in regulated ratemaking. FERC's approval of the income tax allowance as a cost of service for pass-through entities has been upheld by the

United States Court of Appeals for the D.C. Circuit. While not binding on this Commission, FERC's reasoning rejecting the three arguments is compelling. The policy considerations that led FERC to reconsider its income tax allowance policy are relevant in this proceeding.

The Pass-Through Entity.

The Internal Revenue Code (the "Code") governs the income tax consequences of the form in which an entity does business. An S corporation files IRS Form 1120S (an "informational return") but with modest exceptions pays no tax at the corporate level. Instead, its shareholders recognize taxable income *pro rata* on their individual income tax returns via Forms K-1 issued by the corporation. In contrast, Subchapter C corporations report net income **and pay tax** at the corporate level on Form 1120. Tax is imposed upon shareholders only to the extent dividends are distributed. A company whose income (or loss) is reported at the investor level is described as a "pass-through" entity. In some discussions of pass-through entities, the LLC, partnership or S corporation is described as the first tier entity and the investors pay tax at the "second" tier on their *pro rata* share of first tier income.

Most businesses operate as an entity that limits liability to business assets, thus protecting the personal assets of their investors. S corporations are corporations for state law purposes (as are C corporations), including those aspects of limited liability. In 1972, Pima was formed as a Subchapter S corporation. The S corporation was the principal pass-through alternative to the C corporation taxed at the corporate level. Subsequently, amendments to Arizona's Limited Partnership Act (1997) and the enactment of the Arizona Limited Liability Partnership Act in 1994 created viable pass-through alternatives to the S corporation. But with the Legislature's adoption of the Limited Liability Company Act in 1992, LLCs became the preferred choice of entity for business operations.

The pass-through entity is described as "tax efficient," meaning investors' tax burden is minimized. Now, businesses large and small, particularly those holding assets, are generally formed as LLCs. Most publicly traded entities are required to be C corporations, with the exception of oil and natural gas pipelines, many of which are regulated by FERC. In proceedings at FERC, parties objecting to the income tax allowance argued *inter alia* that the pipelines' use of pass-through status (in these cases master limited partnerships or "MLP"s) was inherently improper if not illegal. These arguments have been rejected as lacking legal and factual support. *BP West Coast Products LLC v. SFPP*, 121 FERC ¶ 61,239 (2007).

The argument that Pima (or any pass-through entity) does not pay taxes rests on a faulty technical distinction rather than reality. The income taxes recognized by the shareholders of an S corporation arise directly from the taxable income of the S corporation, just as the income tax a C corporation is subject to arises directly from the

taxable income of the C corporation. Taxes imposed on income are an inevitable business outlay regardless of the entity's legal form. In this respect, income taxes of a pass-through entity are just as much a cost of service as depreciation, salaries and wages, and purchased power. Staff recognized this to be true more than 20 years ago.

There is No Such Thing as Phantom Income Tax.

Staff and RUCO argue that Pima should not receive an income tax allowance because, as a pass-through entity, it does not pay taxes. This argument fails because it confuses the recognition of income with the payment of tax. Income determines tax liability and Pima generates taxable income and, therefore, income tax liability. Pima generates that income from the provision of utility service to its customers. Pima is entitled to recover the costs incurred in the provision of utility service. The fact that the pass-through structure allows the income tax liability generated by Pima to be paid by its shareholders does not change the fact that those taxes are a cost of service. The very concept of a "phantom" tax for pass-through entities ignores the nature and purpose of the income tax. Entities can have net income, have real tax liabilities, and still not pay tax liabilities.

Under the present policy, the Commission has incented utilities to select C corporation status simply because of its unwillingness to allow tax recovery for pass-through entities. The effect of that discriminatory treatment is to discourage the use of legitimate, legal, useful, and lower-cost business structures, which has the further effect of increasing costs to customers, reducing the utility's opportunity to attract capital, and limiting the potential for new infrastructure in Arizona. The question is whether the provision of utility service generates a tax liability – period. The Commission does not, nor should it, change the rates of utilities operating as C corporations based on the actual tax expense of their parent holding companies. Nor should the Commission discriminatorily prohibit Pima and other pass-through entities from recovering their recognized income taxes.

Taxes paid by Pima's shareholders are not disqualified as "personal."

It is argued that income tax reported by Pima is disqualified as a cost of utility service because taxes paid by Pima's shareholders are "personal." True, IRS Form 1040, Individual Income Tax Return, is filed by "people" rather than entities. But taxes paid by a self-employed "person" on income reported at Schedule C and on Form 1040 are no less "business" taxes than those paid by any C corporation. There is no principle of law that discriminates between tax payments to IRS attached to Form 1120 versus those attached to Form 1040. Such an anomalous result aggravates the bad policy outcome of punishing a business for choosing a form that saves investors (and ultimately ratepayers) money.

Summary and Conclusions.

FERC has recently and carefully considered the income tax allowance in the context of regulation of public utilities. As is the case with the Commission, for FERC the rates of regulated entities must be just and reasonable. The regulator must balance the interests of the investor and the consumer. And the regulated entity must be allowed to earn sufficient revenues to maintain fiscal integrity and attract capital. Hence, rates must be neither unreasonably high nor unreasonably low. After consideration, FERC now provides income tax expense recovery for all regulated utilities, including pass-through entities.

Obviously this Commission is not bound by FERC precedent. Nor should the Commission follow FERC because it is FERC. However, orders from FERC and the Federal Courts are relevant in two respects. First, FERC grappled with the "phantom income" argument. FERC thoroughly analyzed, in the Policy Statement on Income Tax Allowance, 111 FERC ¶ 61,139 (2005), and more closely in Orders 511 and 511-A, 137 FERC ¶ 61,220 (2011), the question of whether Tier II taxes are "real." Secondly, FERC reversed the *Lakehead* precedent (Lakehead Pipeline Company, LP, 71 FERC ¶ 61,388 (1995) *reh'g denied* 75 FERC ¶ 61,181 (1996)).

In this proceeding, Pima requests that the Commission re-evaluate whether disallowance of the income tax allowance for pass-throughs is good policy, and FERC's prior undertaking provides invaluable insight into this exact issue. FERC changed its mind because the *Lakehead* precedent did not produce just and reasonable rates and created an artificial impediment to investment in utility infrastructure. In the pipeline sector, much like other businesses, new investment is flowing into pass-through entities. FERC changed its policy in light of the changed circumstances. This Commission should do so as well, after its own analysis, of course, but for similar reasons.

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